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Chinese Concessional Loans
Part 1 — Perceptions and Misperceptions

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Concessional loans account for more than half of Chinese foreign aid (China State Council 2014) and are currently in the spotlight. The Trump Administration's Indo-Pacific strategy targets infrastructure projects funded by Chinese concessional loans in developing countries and pledges to compete with China by providing high-standard infrastructure that is 'physically secure, financially viable and socially responsible' (Pompeo 2018). On the eve of the Forty-ninth Pacific Islands Forum, Tongan Prime Minister 'Akilisi Pohiva intended to urge Pacific nations to band together and press Beijing to forgive debts associated with Chinese concessional loans, although he backed down at the last minute. Chinese loan schemes have also sparked intense debates on debt risks and the Belt and Road Initiative.

Against this backdrop, the nature and ramifications of Chinese loans schemes are examined in this two-part series. Part 1 outlines the nature of Chinese concessional loan schemes and identifies three common misperceptions. Part 2 investigates Pacific indebtedness: the possibility of debt-for-equity deals and what happens when repayments no longer occur.

First misperception: People can easily conflate different types of Chinese financing, viewing all of them as foreign aid. Only grants, and interest-free and concessional loans are calculated as Chinese foreign aid. Various types of finance are provided by China's three policy banks — the Export-Import Bank of China (China Exim Bank), China Development Bank and the Agricultural Development Bank of China. Set up in 1994 by the Chinese government, these policy banks are largely responsible for raising funds and providing loans to support Chinese contractors to carry out large infrastructure projects overseas (see Table 1). As an example of a commercial loan, in November 2014, the Chinese government pledged to set up a special fund of US$1 billion from China Development Bank to support infrastructure development in the Pacific, though details of implementation remain inaccessible.

Second misperception: Some people may think Chinese concessional loans can be written off when recipient countries lack repayment capacity. These differ from interest-free loans which are often forgiven by Beijing in high-profile cases,[1] because both the principal and interest of concessional loans are required to be repaid.

Table 1: Chinese foreign aid

<table>
<tr><th>Type of finance</th><th>Chinese foreign aid?</th><th>Comments</th></tr>
<tr><td>Grants</td><td>√</td><td></td></tr>
<tr><td>Interest-free loans</td><td>√</td><td>Can be forgiven.</td></tr>
<tr><td>Concessional loans</td><td>√
See details below</td><td>China Exim Bank
• interest rate 2% to 3%
• 15 to 20 repayment years, including 5 to 7 years' grace
• must be repaid.</td></tr>
<tr><td colspan="3">Examples:
i. University of Goroka dormitory construction (2011–14); phases 2 to 4, US$45.9 million (RMB 294 million), China's first concessional loan project in Papua New Guinea.
ii. Reconstruction of central business district in Nuku'alofa, Tonga (2008–12), US$68.7 million (RMB 440 million).</td></tr>
<tr><td>Commercial loan schemes</td><td>X</td><td>i. China Exim Bank
ii. China Development Bank
iii. Agricultural Development Bank of China.</td></tr>
<tr><td colspan="3">i. Export buyers' credits.
ii. China–Africa Development Fund, the Special Loan for the Development of African Small and Medium-sized Enterprises, Fund for Development Cooperation between China and Portuguese-speaking Countries, Special Fund for Infrastructure Development in Pacific Island countries et cetera.
iii. Loans to support large overseas agricultural projects.</td></tr>
</table>

Governments of developing countries are interested in Chinese concessional loans for four reasons:

1. Demand for external funds to promote economic and social development. For example, infrastructure investment needs in Asia over between 2016 and 2030 are estimated to be US$1.7 trillion per annum while the current investment level is US$881 billion (ADB 2017, p. xi), leaving a huge gap of US$811.9 billion.

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2. Compared with funds from traditional donors and international financial institutions, Chinese concessional loans appeal to recipient governments because fewer conditions are attached to them (e.g. democratic, governance, human rights and financial reform) and a faster approval process.
3. Chinese contractors, especially the state-owned enterprises (SOEs), bid for infrastructure projects in recipient countries at competitive prices. They can easily access Chinese concessional loans to implement these projects. However, these can be subject to fraudulent practices — some Chinese contractors may intentionally bid lower prices and then keep pressing recipient governments to increase the budget after they win the contract (Chinese government Procurement Network 2016), which pushes up the project cost and contributes to rising debts. For example, China Communication Construction Corporation and all its subsidies, including China Harbour Engineering Company, were blacklisted by the World Bank until January 2017 for fraud in a Philippines roads project. CHEC, an active player in the Pacific infrastructure sector, has also been heavily criticised by some Pacific politicians,[2] Pacific media and even Chinese peer contractors (author's interview, November 2014).
4. Misconception of Chinese concessional loans: some officials in recipient countries may assume they can request Beijing to forgive mature loans , or turn loans into interest-free loans and ultimately write them off; other officials may be aware of the difficulties in writing off concessional loans, but still hope China may do so for the sake of bilateral political relations, neither of which is correct.

China is fond of providing concessional loans for three reasons. First, compared with grants and interest-free loans, concessional loans must be repaid, which reduces the financial burden of the Chinese government, especially as demands for Chinese aid are steadily growing. Second, as required by the concessional loans agreement, Chinese contractors, especially SOEs, will be awarded the contracts to implement loan projects. In this sense, concessional loans play a significant role in supporting Chinese companies' *zou chuqu zhanlue* ('going out strategy') to explore overseas markets, create their brands and access natural resources and energy to fuel China's economic development. Third, Chinese concessional loan projects provide job opportunities for Chinese workers and generate revenue for Beijing. This point is of more relevance when China is offshoring excess manufacturing capacity. It also explains why these loan projects use a large proportion of Chinese labour, equipment and building materials.

Third misperception: Chinese aid calculation can also be frustrating. Chinese concessional loan funds are raised by China Exim Bank from the capital market at a commercial interest rate and are then lent to recipient countries as Chinese aid at a concessional interest rate. The difference between the two rates is covered by the Chinese foreign aid budget and reimbursed by the government; however, the full face value of concessional loans is calculated as Chinese foreign aid. While traditional donors (e.g. members of the OECD Development Assistance Committee) deduct loan repayments from their official development assistance amount, referred to as net ODA, Beijing does not use this indicator of net foreign aid, which means China will not net off repayment of its concessional loans in its aid calculations. Furthermore, some traditional donors, such as the United States of America and Australia, include grant aid only in their ODAs. By contrast, concessional loans have become the largest component of Chinese aid and that proportion continues to grow. These differences demand attention when discussing traditional ODA and Chinese foreign aid to avoid the risk of comparing apples and oranges.

Summary

Chinese foreign aid includes concessional loans but excludes commercial loans. Concessional loans are required to be repaid. Both China and recipient countries need to carefully consider the repayment capacity of Pacific Island countries before loans are granted. Part 2 of this series on Chinese concessional loans examines non-payment of loans and the possible repercussions for PICs, as revealed by recent research.

Author notes

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Endnotes

1. For example, President Xi Jinping announced at the United Nations in September 2015 that China would write off outstanding interest-free loans due by the end of 2015 owed by relevant least-developed countries, landlocked developing countries and small island developing countries.
2. The Lae Port development is CHEC's first project in PNG. CHEC claimed it was a great success but this was discounted by Don Pomb Polye, Leader of the PNG Opposition, as a failure. Main project funder ADB acknowledged that design changes had led to an additional cost of US$137 million.

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